HM TREASURY

Exchange Equalisation Account: Report and Accounts 2010-11

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Exchange Equalisation Account: Report and Accounts 2010-11

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Foreword

Introduction

1. The Exchange Equalisation Account (EEA) holds the United Kingdom's reserves of gold, foreign currency assets and International Monetary Fund (IMF) Special Drawing Rights[1] (SDRs). Combined with the UK's Reserve Tranche Position (RTP) at the IMF and bilateral loans to the IMF, these assets comprise the UK's official holdings of international reserves ("the official reserves"). The RTP and IMF bilateral loans are held in the National Loans Fund (NLF).

2. The Bank of England (the Bank) acts as the Treasury's Agent in the day-to-day management of the EEA. The Bank executes foreign exchange transactions and invests the reserves in accordance with a framework set out in a Service Level Agreement (SLA) agreed annually between the Bank and the Treasury (see paragraph 9)[2].

3. The Bank also acts as the Treasury's Agent for foreign currency liability management, including the issuance of foreign currency debt to finance some of the reserves. This debt is issued by, and is an obligation of, the NLF under the National Loans Act 1968 since it is that Act (rather than the Exchange Equalisation Account Act 1979) which provides the powers for the Government to issue foreign currency securities. The foreign currency raised by issuing foreign currency debt is transferred to the EEA (see paragraph 22). At 31 March 2011 there was no foreign currency debt outstanding (*2010: nil*).

4. The Bank manages the foreign currency assets and liabilities associated with the reserves of the NLF in conjunction with those of the EEA as the Treasury's Agent. This allows the foreign currency assets and liabilities associated with the reserves, and the risk exposures therein, to be managed collectively in an efficient way. These are the financial accounts of the EEA only, but where relevant the management commentary covers issues relating to the NLF assets and liabilities that are managed as part of the official reserves.

Origin and Purpose

5. The EEA was established in 1932 to provide a fund that could be used, when necessary, to regulate the exchange value of sterling, and therefore is the mechanism through which any UK Government exchange rate intervention would be conducted. During the year the Government intervened in the foreign exchange market on one occasion. This is explained further in paragraph 47.

6. Against this background, foreign currency reserves are held on a precautionary basis - to meet any change in exchange rate policy in the future, if required, or in the event of any unexpected shocks. The reserves are also used to provide foreign currency services for government departments and agencies, to provide foreign exchange for making payments abroad and to buy, sell and hold SDRs as required by the UK's membership of the IMF. The Treasury's prime objective in managing the EEA on behalf of the Government is to ensure the reserves are fit for purpose in order to meet current policy objectives and any potential future changes in policy.

[1] This and other terms are defined in the Glossary at the back of this document.
[2] A summary is included in a report produced by HM Treasury entitled 'Management of the Official Reserves' available at www.hm-treasury.gov.uk/d/management_offical _reserves.pdf

7. Under the Exchange Equalisation Account Act 1979, the EEA is permitted to invest its funds in any assets denominated in the currency of any country, to purchase gold, and to acquire SDRs.

Administration and Control

8. The EEA is under the control of the Treasury, which has appointed the Bank to act as its Agent to carry out dealing in foreign currencies and the investment of the reserves. The Bank also provides advice and analysis to the Treasury on issues relating to the reserves. The Bank's management costs are charged to the EEA. The management charge in 2010-11 was £8m *(2010: £9m)*.

9. An annual Service Level Agreement (SLA) between the Treasury and the Bank specifies the parameters within which the reserves are managed. There were no substantive changes to the SLA in 2010-11. The SLA specifies:

- benchmarks[3] which specify the currency and asset composition of the reserves;
- limits to the Bank's discretion to take currency or interest rate positions relative to those benchmarks;
- the framework for controlling credit, market, liquidity and other risks;
- a target return for active management compared to benchmark positions; and
- the programme for financing the reserves, covering the NLF's foreign currency borrowing and currency swaps out of sterling.

The terms of the SLA can be reviewed during the year at the Bank's or the Treasury's request.

10. The Bank reports to the Treasury on size, composition and liquidity of the reserves and their continued consistency with policy objectives, investment performance, returns made and risk exposures, including those relating to active management, every month and at a quarterly meeting chaired by the Deputy Director responsible for the Debt and Reserves Management team. Every six months there is a meeting at which the EEA Accounting Officer (currently HM Treasury's Chief Economic Adviser) and the Bank of England's Executive Director for Markets, or delegated senior officials, review investment performance and discuss strategic issues relating to the reserves.

Key performance indicators

11. The Treasury has agreed with the Bank a set of Key Performance Indicators (KPIs). The purpose of these KPIs is to provide a basket of indicators that can be used to assess the future effectiveness of the management of the EEA.

12. The KPIs selected reflect the overall objectives for holding the reserves, as explained in detail above. The Treasury's prime objective in managing the EEA on behalf of the Government is to ensure the reserves are fit for purpose in order to meet current policy objectives and any potential future changes in policy. In support of that, the Government's

[3] Benchmark is the neutral or passive investment strategy for the reserves portfolio. Active management performance is measured against a target return over the benchmark.

objective is to preserve the liquidity and security of the reserves and to ensure that the Government maintains its capability to intervene in the foreign exchange market if required. Subject to this, the aim is to minimise the overall cost of holding the reserves, while ensuring exposure to financial risk is limited through the appropriate choice of portfolio and risk management practices.

13. The Treasury's role in this is to ensure that its choice for the strategic composition for the benchmark asset allocation of the reserves, including gold, meets the policy objectives set out above. Subject to meeting those objectives, the Treasury will make that benchmark asset allocation choice to trade off risk, return and liquidity in line with its risk preferences.

14. The KPIs are that:

(i) The foreign currency reserves, whilst not employed in operations to deliver on policy objectives, will be invested in assets that are liquid and secure and are monitored daily. Specifically:

- A minimum of 90% will be held in tradeable debt securities and cash;
- A minimum of 90% will be invested in assets that are rated equivalent to at least AA-, (Aa3) by two or more of the rating agencies (Moody's, Standard and Poor's, and Fitch), or an equivalent internal measure for unrated entities;
- All assets must be rated investment grade by two or more of the rating agencies (Moody's, Standard and Poor's, and Fitch), or an equivalent internal measure for unrated entities.

(ii) The Bank will observe the limits as set out in the SLA. In line with the SLA, any substantive breaches of the limits and/or any operational errors will be reported to the Treasury as soon as possible, along with advice on how the Bank will deal with them. Any significant breach will be reported publicly (e.g. in the annual accounts).

(iii) In order to aim to at least cover costs, and to ensure the Bank maintains its capability to intervene in the foreign exchange market if required, the Bank will actively manage the EEA portfolio against the benchmark to meet the active management return target set by the Treasury (see paragraph 45 for details), whilst ensuring compliance with the limits as detailed in the SLA.

(iv) The Bank will ensure that all transactions related to government departments and the IMF shall be handled efficiently, accurately and in a timely fashion.

(v) In carrying out its services, the Bank will as far as possible ensure that:

- its management and staff are of high repute and integrity;
- staff training and experience are appropriate for the tasks they are expected to undertake and consistent with the amount of risk they are authorised to take;
- its internal systems and controls are adequate for the size, nature and complexity of EEA operations and comply with best market practice so far as possible;
- appropriate preparations are made for possible policy deployment of the reserves (e.g. FX intervention).

15. During the 2010-11 financial year there was a holding of £142 million (0.3% of the gross reserves), which did not meet the KPI that all assets should be rated investment grade by two

or more of the rating agencies, or an internal equivalent measure for unrated entities. All other KPIs were met.

Investment Policy

16. EEA investments need to be highly liquid in order that they can be made available for use quickly, whilst minimising the costs of holding the reserves. Inevitably, these investments carry some element of credit risk. In order to reduce this risk and to ensure the necessary liquidity, the EEA predominantly holds securities issued or guaranteed by the national governments of the United States, Euro area countries and Japan.

17. The EEA is permitted to use other financial instruments, including:

- Conventional bonds, bills, discount notes and floating rate notes of any maturity and commercial paper issued by other national governments, supranational organisations and selected official sector agencies;
- foreign currency spot, forward and swap transactions;
- interest rate and currency swaps;
- overnight indexed swaps;
- bond and interest rate futures, swap notes and swap futures;
- sale and repurchase, sell-back, and buy-sell back agreements;
- forward rate agreements;
- SDRs;
- short-term bank deposits;
- deposits with the Bank;
- bank certificates of deposits and commercial paper; and
- bank conventional bonds of any maturity explicitly guaranteed by a national government or official sector agency whose own obligations are authorised investments.

Management Commentary

18. At Budget 2011, the Chancellor announced an additional £6 billion of sterling financing for the Official Reserves in 2011-12. The Government envisages sterling financing being held at a similar level on average over the three years up to, and including, 2014-15. This sterling financing will be sufficient to meet potential calls on the Official Reserves from the International Monetary Fund and ensure the level of foreign currency reserves held is sufficient.

Hedged and unhedged reserves

19. The UK's official reserves, of which £48,954m *(2010: £43,355m)* are held in the EEA and £4,391m *(2010: £2,318m)* are held in the NLF, can be divided into two components: reserves that are hedged for currency and interest rate risk of £27,680m (*2010: £23,872m*) (the 'hedged

reserves'), and the remaining reserves of £25,665m (*2010: £21,801m*) which are unhedged (the 'unhedged reserves'). The rise in the hedged reserves is due primarily to additional financing provided by the NLF. The rise in unhedged reserves is due primarily to an increase in the value of gold holdings and additional lending to the IMF.

20. The unhedged reserves comprise dollar and euro denominated bonds, gold, IMF lending (which is part of the NLF) and yen exposure normally obtained through forward yen purchases. The unhedged reserves are in the main financed out of sterling through accumulated retained earnings and sterling financing provided by the NLF. A small element of the unhedged reserves is financed by the EEA's net SDR position.

21. The hedged reserves comprise portfolios of eligible dollar, euro and yen denominated assets and holdings of SDRs. Assets in the hedged reserves are hedged for currency risk either by being denominated in the same currency as the liabilities which finance them or by using currency swaps. The hedged reserves are also hedged against interest rate risk, through the use of swaps.

22. The hedged reserves are primarily financed by sterling raised from the sale of gilts. The EEA uses sterling advanced from the NLF to purchase foreign currency assets with, as noted above, swaps used to hedge the resulting currency and interest rate risks. However, the Government retains the option of issuing foreign currency denominated securities taking into account cost, risk, market conditions and consistency with debt management objectives. As explained in paragraph 3, the issuance of foreign currency securities is effected through the NLF and the resulting foreign currency proceeds are treated as being sold for sterling to the EEA, with the NLF advancing the EEA the sterling required as necessary.

23. Financing of the hedged reserves as at 31 March 2011 included sterling swapped into foreign currencies of £14,546m (*2010: £8,717m*) and the SDR allocation of £10,024m (*2010: £10,144m*). There were no outstanding foreign currency securities at the end of the year (*2010: nil*). No new foreign currency securities were issued during the year (*2010: nil*).

Management of the reserves

24. As noted above, the relevant foreign currency assets and liabilities of the NLF are managed together with the EEA to enable integrated management of the overall UK official foreign currency reserves.

25. The foreign currency elements of the total UK's official reserves are published in the monthly IMF Reserves Template[4]. The Template shows the net foreign currency position in the official reserves, which at end-March was the equivalent of £25,665m. The assets and liabilities in the Template differ from those of the EEA Statement of Financial Position on page 22 of these accounts. This is for a number of reasons, but principally it is because the Template is designed to reflect the UK's foreign currency position. Therefore it includes foreign currency assets and liabilities of the NLF (notably the RTP) and excludes all items denominated in domestic currency (i.e. sterling). The most significant of these are the liability of the EEA to the NLF and the valuation of the sterling leg of foreign currency forwards and currency swaps. These factors, coupled with the effects of differing accounting treatment of collateral and unsettled items, mean that gross reserve assets shown in the Template (the equivalent of £53,345m at 31 March 2011) differ by £217m from the assets held in the EEA. A reconciliation between the EEA's Statement of Financial Position and the Template is provided on 13.

[4] This can be viewed at: http://www.hm-treasury.gov.uk/press_notices_index.htm

26. The size of the official reserves assets that are held in the EEA rose over the course of the year by £5,599m to £48,954m. This increase consisted primarily of rises in debt securities (£5,376m), value of gold (£1,620m) and unsettled trades (£384m), offset by a decrease in reverse repurchase agreements (£1,899m).

27. The reserve liabilities held in the EEA rose over the course of the year by £3,808m to £27,680m. This increase consisted primarily of rises in net derivative positions (£3,529m), repurchase agreements (£316m) and unsettled trades (£84m), offset by a decrease in the sterling value of the SDR allocation (£120m).

28. In the EEA Statement of Financial Position shown on page 22 assets increased over the course of the year by £6,314m to £53,128m. This increase consisted primarily of rises in debt securities (£5,277m), value of gold (£1,620m), cash balances (£959m) and treasury bills (£356m), offset by a decrease in reverse repurchase agreements (£1,899m) and items in course of collection (£111m).

29. A matching increase in EEA liabilities consisted primarily of rises in the liability to the NLF (£6,964m) and repurchase agreement (£316m), offset by a fall in derivative liabilities (£725m) and items in course of transmission (£411m).

30. There has continued to be turbulence in European Sovereign debt markets during the year. This ongoing situation continues to be monitored closely, and its potential impacts on the liquidity and security of the portfolio assessed through stress tests. In this context, credit risk limits to both counterparties and issuers have been closely monitored and adjusted as necessary throughout the year.

Benchmark allocations

31. In accordance with the SLA, the Bank manages the reserves so as to ensure adherence to Treasury policy aims and thereby maintain their liquidity and security and, subject to that, so as to minimise the cost of holding the reserves. The Bank and the Treasury agree in the SLA a series of benchmarks for the assets in which the reserves are invested. These represent the high-level asset allocation decision, reflecting the policy objectives of the reserves, and also form the benchmark against which the Bank's active management is measured.

32. In order to determine the benchmark asset allocation for the hedged reserves of the EEA, the Bank uses an asset allocation model, the parameters of which are agreed by the Treasury, which explicitly trades off liquidity and return. The model determines an asset mix that maximises expected return for given estimated levels of expected liquidation costs.

33. The Treasury also sets a benchmark for the currency allocation of the EEA's unhedged reserves excluding gold. This takes into account past patterns of risk and return, as well as other factors such as the currencies likely to be required in any intervention. As in the previous year, in 2010-11, this benchmark was 40% US dollar, 40% euro and 20% yen. However, following the intervention in March 2011 (see paragraph 47) automatic benchmark purchases of yen were suspended, as such purchases would have been inconsistent with the policy objective of intervention. This resulted in a divergence from the usual benchmark currency allocation at the end of the year.

34. Each currency within the unhedged reserves has a benchmark for the assets within it. The benchmark for assets denominated in US dollars comprised a combination of US Treasury and other US dollar denominated bonds. The benchmark for euro denominated assets

comprised euro denominated sovereign securities. For yen, the benchmark was derived from 1-3 month forward rates against the euro and the dollar.

35. A short-term liquidity portfolio is used to manage cash flows arising from the hedged and unhedged reserves. The size of this portfolio is such that the scope for active management is very small and it does not have an explicit benchmark for this reason.

36. There is no benchmark for the RTP and bilateral lending in the NLF given that there is no discretion, under IMF membership rules, to alter this holding.

Links between the International Monetary Fund and the official reserves

37. The primary means of financing the IMF is through members' quotas. Each member of the IMF is assigned a quota, based broadly on its relative position in the world economy, which is payable in a combination of SDRs and the member's own currency. The difference between a member's quota and the IMF's holdings of its currency is a member's RTP. As explained above, the UK's RTP is an asset of the NLF. The IMF remunerates most of the RTP at slightly below the level of the SDR interest rate, although a portion of the RTP is unremunerated.

38. While quota subscriptions of member countries are the IMF's main source of financing, the Fund can supplement its resources through borrowing if it believes that resources might fall short of members' needs. Through the General Agreement to Borrow (GAB) and the New Arrangements to Borrow (NAB), a number of member countries and institutions, including the UK, stand ready to lend additional funds to the IMF. The bilateral loan to the IMF, signed in 2009, has now been incorporated into an extended NAB. Any lending against this facility is an asset of the NLF.

39. The IMF has periodically issued SDRs and allocated them to members in proportion to their quotas. The UK's SDR allocation is a liability of the EEA and the resultant holding of SDRs by the UK is an asset of the EEA. IMF members are credited with interest on their holdings of SDRs and pay interest on their allocation of SDRs at the same rate.

Analysis of returns for the period

40. The EEA's accounts for the year ended 31 March 2011 are given on pages 21 to 44 and show total comprehensive income for the year of £1,764m (*2010 restated: £962m*). This profit was largely driven by gains on gold holdings.

41. The price of gold rose from £735 to £898 an ounce, an increase of 22%, giving rise to a revaluation gain of £1,620m.

42. Fair value losses on financial instruments for the year were £242m (*2010: £428m*). These losses arose on the unhedged reserves, primarily as a result of sterling appreciation during the year against the euro and US dollar. On a financial instrument basis, fair value losses on debt securities of £939m *(2010: £1,248m)* were the largest contributor, although these losses were partially offset by hedging gains on currency swaps of £333m *(2010: £570m*) and gains on foreign exchange transactions of £223m *(2010: £154m).* The nature of the hedging relationship between currency swaps and foreign exchange transactions, and the debt securities being hedged by them is that gains on swaps and foreign exchange transactions will tend to be offset by losses on the debt securities that they hedge, and vice versa.

43. The total interest receivable from the EEA's portfolio of assets was £846m (*2010: £916m*). As in previous years, this consisted primarily of interest received on debt securities of £721m (*2010: £776m*) and sterling legs of currency swaps of £51m (*2010: £75m*).

44. Total interest payable of £452m (*2010: £474m*) led to net interest income of £394m (*2010: £442m*). The interest payable figure consisted primarily of the interest expense on the foreign currency legs of currency swaps of £324m (*2010: £382m*) and interest rate swaps of £62m (*2010: £55m*).

45. The Treasury sets a target for active management return as part of the SLA, above the cost of managing the reserves. This target is set against the benchmarks for the portfolio (as detailed above), and takes account of the limits on active management set as part of the SLA. This target is confidential for policy reasons. The return from the Bank's active management of the reserves against the benchmarks during the year was £16m (*2010: £26m*).

46. The EEA continued to invest in high credit quality assets throughout the year, and has not crystallised any credit losses as a result of market turbulence.

Intervention

47. If the Government so instructs, the Bank, acting as its agent, may intervene in the foreign exchange market. On 18 March 2011, the Bank of England acting as agent for HM Treasury, and at the request of the Japanese authorities, joined Japan and the authorities of the United States, Canada and the European Central Bank in a concerted G7 intervention in foreign exchange markets. This intervention was in response to movements in the exchange rate of the Japanese yen associated with the devastating earthquake and tsunami in Japan. The Bank sold ¥12bn for £93m. This was the first coordinated G7 intervention since 2000.

Provision of Foreign Currency Services to Government Departments

48. The EEA continued to provide foreign currency services to various government departments and agencies, i.e. sales of foreign currency to departments with foreign currency obligations and purchases of foreign currency from departments with foreign currency receipts, in aggregate totalling £11,642m (*2010: £14,297m*). The decrease was due to a fall in forward transactions on behalf of the Ministry of Defence. These purchases and sales, both spot and forward, were hedged through offsetting trades with the market.

Risk Management and Control

49. Although the reserves are not held primarily to make a profit, consistent with the KPIs (see paragraphs 11 to 15), the Treasury seeks to minimise the cost of holding the foreign currency reserves whilst avoiding exposing the public purse to unnecessary risk.

50. Risk is managed through an established control framework, including setting limits to credit risk and market risk exposures, combined with clear operational guidelines.

Control Framework

51. The key features of the control framework during the year were as follows:

- An annual Service Level Agreement (SLA) was agreed between the Treasury and the Bank, in which the Treasury set out the parameters under which the Bank was to manage the reserves. A summary of the SLA was published in the Debt and Reserves Management Report[5].

[5] Available at www.hm-treasury.gov.uk/d/management_offical_reserves.pdf

- The Bank produced a quarterly report for the Treasury on risk controls and any breaches of the control framework.
- There is a system of financial reporting. Each month the Bank reported to the Treasury on the returns made and the market and credit risks incurred.
- The EEA Accounting Officer and the Bank's Executive Director, Markets met together with Treasury officials twice in the year to review the management of the reserves. Quarterly meetings between Treasury officials and Bank officials supplemented this process.
- A risk-based internal audit programme (agreed with the Treasury) that delivered reports to the Bank's Executive Director, Markets, as well as a quarterly report which is forwarded to the Treasury.
- There is an organisational structure in the Bank containing clear reporting lines. The Bank's Risk Management Division, which analyses financial risk and Markets Strategy and Risk Operations Division, which produces returns and risk information, are independent of the Foreign Exchange Division where trading activities were conducted. The Risk Management Division, Markets Strategy and Risk Operations Division and the Foreign Exchange Division report to the Bank's Executive Director, Markets. Settlements of transactions were carried out by the Customer Banking and Market Services Divisions, which report to the Executive Director, Banking Services.
- Operational Risk Officers in the Bank's Foreign Exchange, Risk Management, and Markets Strategy and Risk Operations Division were responsible for co-ordinating and collecting analysis on the operational risk in the Divisions.
- The Bank tested its remote contingency facilities where EEA operations can be carried out in an emergency.

The limits to credit and market risk exposures are explained in the following paragraphs.

52. Credit risk: the management of the reserves involves exposure to counterparties and to the issuers of securities. The creditworthiness of these counterparties and issuers is subject to regular scrutiny by the Bank, both through analysis in the Risk Management Division and review by the Bank's Credit Ratings Advisory Committee. Following this process, limits are agreed for the exposure to each counterparty and issuer, with such exposures being monitored in real time against the limits. Any limit excesses are reported to the Treasury each month. In addition, there are limits to contain the overall exposure to each relevant country's banking sector.

53. The arrangements for custody of EEA assets in 2010-11 were as follows. US Treasury bonds and other US dollar denominated securities were held in custody at the Federal Reserve Bank of New York. Euro denominated securities were held in custody at Clearstream. Japanese bonds were held in custody at the Bank of Japan. The gold bars and gold coin in the reserves were stored physically at the Bank's premises.

54. Market risk: market risk is the exposure to movements in market variables. For the EEA, the main market variables are interest rates and exchange rates. The Bank monitors and controls market risk on active management positions primarily by using a Value at Risk (VaR) model, which predicts, at a specified confidence level, the maximum likely loss for the portfolio over a certain time period. The Bank applies a 99% confidence interval and a two-week holding period, implying that losses should not exceed those suggested by the model in ninety-nine two-week periods out of a hundred. The VaR estimates are based on the historic volatility of returns on different asset classes and the historic correlation between returns on

those asset classes. The Bank uses these data to generate two VaR measures: an unweighted VaR where an equal weight is assigned to historic market data, and an exponentially-weighted VaR which gives greater weight to more recent historic market data. The higher of these two numbers is then reported as VaR.

55. The Bank measures the VaR on active management positions on a daily basis. Estimates of the VaR arising from the choice of benchmark asset allocation are also produced, and reported to the Treasury on a regular basis. The Bank undertakes regular back-testing of the VaR model. The Bank also measures the delta exposures on active management positions. Delta measures the change in value of the portfolio for each one basis point shift in the relevant yield curve.

56. The Bank also conducts regular stress tests for a range of scenarios.

Operational Guidelines

57. In addition to the above control framework, risk was further managed by the following operational guidelines.

58. The Treasury's financing of the hedged foreign currency reserves, whether through borrowing directly in foreign currency or by engaging in foreign currency swaps out of sterling (see paragraph 21), was done in a way that minimised the exposure to fluctuations in the value of currencies.

59. Where financing was through sterling, currency swaps were used to hedge exchange rate risk. This was done through an initial exchange of sterling principal for foreign currency at the spot rate, receiving back the same amount of sterling principal at maturity, and regular exchanges of interest payments on the principal amounts. Similarly, where funding was through sterling, interest rate risk was hedged through interest rate swaps. Typically, the EEA paid fixed rate interest on the currency it acquired and generated fixed interest income in the same currency through purchasing an asset such as a bond. By swapping the fixed interest receipts for floating interest receipts through an interest rate swap, the EEA acquired an income stream that matched its interest payment liability and thus minimised its interest rate exposure.

60. The above arrangements produced a portfolio of assets that closely hedged the obligations to repay the NLF's foreign currency liabilities.

61. In the unhedged reserves, the Treasury may decide, with advice from the Bank, to set deviations from the 40:40:20 currency benchmark or the interest rate benchmarks. As noted in paragraph 47, in 2010-11 intervention operations were undertaken by the Bank as instructed by the Government.

62. Under the SLA, the Bank actively managed the hedged and unhedged reserves, in order to improve the return. The Treasury sets the Bank a VaR limit for active management relative to benchmarks, with the VaR being calculated at close of business each day. In 2010-11 the VaR limit for active management was \$20m. During the year the Bank's use of VaR did not exceed \$5.17m. The average use of VaR during the year was \$2.50m and the lowest VaR usage at the end of any one day was \$1.16m.

Audit

63. The EEA account is audited by the Comptroller and Auditor General under the requirements of the Exchange Equalisation Account Act 1979.

64. As the Accounting Officer, I have taken all the steps that I ought to have taken to make myself aware of any relevant audit information and to establish that the EEA's auditors are aware of that information. So far as I am aware, there is no relevant audit information of which the EEA's auditors are unaware.

David Ramsden	HM Treasury
Accounting Officer	12 July 2011

Reconciliation of EEA Statement of Financial Position to IMF Reserves Template

As at 31 March 2011	Unaudited **£ millions**	Unaudited **$ millions**
Total assets per EEA statement of financial position	**53,128**	
Adjustments to reflect IMF Reserves Template presentation:		
Eliminate sterling cash balance	(1,249)	
Reclassification between assets and liabilities	(2,929)	
Other adjustments	4	
Reserve assets held in the EEA	48,954	
Reserve assets held in NLF	4,391	
Sterling total assets using Template presentation	**53,345**	
Dollar equivalent per Template		**85,507**
Total liabilities per EEA statement of financial position	**53,128**	
Eliminate EEA's Liability to the NLF (see note 17)	(37,157)	
Adjustments to reflect IMF Reserves Template presentation:		
Eliminate sterling leg of derivative trades	14,646	
Reclassification between assets and liabilities	(2,929)	
Other adjustments	(8)	
Sterling total liabilities using Template presentation	**27,680**	
Dollar equivalent per Template		**44,368**
Net assets per Template	**25,665**	**41,139**

Conversion rate into US dollars is 1.6029 as at close 31 March 2011

Statement of the Accounting Officer's Responsibilities

Under the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000), the Treasury is required to prepare for each financial year, in such form and on such basis as they may prescribe, accounts in relation to the transactions, assets and liabilities of the Account.

The accounts are prepared on an accruals basis and to give a true and fair view of the state of affairs of its income and expenditure and cash flows for the financial year.

The Treasury has appointed its Chief Economic Adviser as the Accounting Officer for the Account, with responsibility for preparing the accounts and for transmitting them to the Comptroller and Auditor General.

In preparing the accounts, the Accounting Officer is required to comply with an Accounts Direction and in particular to:

a observe the relevant accounting and disclosure requirements, and apply suitable accounting policies on a consistent basis;

b make judgements and estimates on a reasonable basis;

c state whether applicable accounting standards have been followed, and disclose and explain any material departures in the accounts; and

d prepare the accounts on a going-concern basis.

The responsibilities of an Accounting Officer, including responsibility for the propriety and regularity of the public finances for which an Accounting Officer is answerable, for keeping proper records and for safeguarding the Department’s assets, are set out in Chapter 3 of “Managing Public Money”. The Accounting Officer’s Statement on Internal Control can be found on page 15.

Statement on Internal Control

1. Scope of responsibility

1.1 As Accounting Officer for the Exchange Equalisation Account (EEA), I have responsibility for maintaining a sound system of internal control that supports the achievement of the policies, aims and objectives of the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000) as well as the targets set by Treasury Ministers, whilst safeguarding the public funds and assets for which I am personally responsible, in accordance with the responsibilities assigned to me in 'Managing Public Money'.

1.2 The management of the EEA is divided between the Treasury and the Bank of England (the Bank). The EEA is under the control of the Treasury. The Bank is the Treasury's Agent and is responsible for the day-to-day management of the EEA, within the framework set by the Treasury. The Debt and Reserves Management (DRM) team at the Treasury has oversight of the Bank's EEA operations and agrees an Annual Service Level Agreement (SLA) with the Bank that specifies the parameters under which the reserves are managed. The SLA sets out the guidelines for investing the reserves, including risk limits and the associated management information required. The Exchequer Funds and Accounts (EFA) team at the Treasury reports directly to me on operational risk issues and works closely with the Bank to produce the annual accounts.

2. The purpose of the system of internal control

2.1 The system of internal control is designed to manage risk to an acceptable level, balancing the impact of potential risks with the resources to manage them, rather than to eliminate all risk. It can therefore only provide reasonable and not absolute assurance of effectiveness. The system of internal control is based on an ongoing process designed to identify and prioritise the risks to the achievement of the EEA's policies, aims, and objectives; to evaluate the likelihood of those risks being realised and the impact should they be realised; and to manage them efficiently, effectively and economically. The system of internal control has been in place throughout the year ended 31 March 2011 and up to the date of approval of the annual report and accounts, and accords with Treasury guidance.

3. Capacity to handle risk

3.1 The risk management strategy is set annually via the SLA, which is signed by me as Accounting Officer. There is clear segregation of duties within the Bank and the Treasury for the management of the EEA and the supporting processes.

3.2 At the Bank, senior management are responsible for ensuring that their staff have skills and receive training appropriate to their responsibilities. Those involved in managing financial and other risks have their objectives set accordingly, including responsibility for relevant aspects of the control framework. Policy and procedures manuals as well as job instructions are maintained to ensure staff carry out their responsibilities in a controlled manner. Where there are instances of control failure, staff are required to maintain a record in an incident log. These are reviewed on a regular basis to ensure lessons are learned and control improvements implemented. Control improvements and responses to control failures are summarised in the quarterly Turnbull (Risk) report from the Bank to EFA described below.

3.3 At the Treasury, management ensures that specific DRM and EFA staff are trained in risk appraisal and management. Individuals' objectives reflect the need to manage risk. Job instructions are maintained for time and business-critical tasks.

4. The risk and control framework

4.1 Within the Bank, the Risk Management Division is responsible for financial risk analysis and risk methodologies, whilst Markets Strategy and Risk Operations Division is responsible for: running, developing and stream-lining the operations and processes in Markets which underpin risk management; reconciling and producing the EEA financial and management accounts; and all Markets-wide crisis and contingency planning. Both divisions are independent from the Foreign Exchange Division where transactions are executed. The Risk Management, Markets Strategy and Risk Operations, and Foreign Exchange Divisions are independent from the Banking Services Directorate where the transactions are settled.

4.2 The Bank has an overarching Risk Management Framework in order to provide consistency and transparency in operational risk management processes across the organisation. This framework is supported by a central Risk Oversight Unit in the Finance Directorate and ultimately overseen by the Business Risk Committee (BRC). The framework identifies the roles and responsibilities of the key parties involved in the risk management processes, the policies for how risks are managed, and the reporting outputs that are generated. The risk policies are set out in the Strategic and Policy Risk Statement, the Operational Risk Policy and in a number of Risk Standards. The Standards are a high-level articulation of how key categories of risk are identified, assessed, controlled and monitored within the Bank. Those relevant to the management of the EEA include the operational risk standards: Business Practice Risk, Information Technology Risk, Security Risk, Business Continuity Risk, Project Risk and Human Resources Risk. The BRC ensures that these Policy and Risk Standards are "fit for purpose", and reviews them on an annual basis prior to approval by the Governors. Each Bank Directorate reports its risk profile quarterly to BRC, as do Risk Standard Owners in respect of each Risk Standard. Mitigating actions in response to incidents and exceptions relating to the Bank's risk profile, are also reported to the BRC.

4.3 At the Treasury, EFA is responsible for monitoring the risk environment and providing the Accounting Officer with the assurance to sign off the Statement on Internal Control. DRM are responsible for monitoring the performance of the Bank in managing the reserves. To support these processes, the Bank provides the following management information:

- Monthly financial reporting detailing, on a management accounting basis, the returns made with respect to the management of the EEA and the market and credit risks incurred. Management accounts are reconciled to financial accounts.
- The Bank's Executive Director for Markets provides the Accounting Officer with a quarterly assurance that the processes and framework in place are sufficient to identify current and future sources of material risk and meet the Turnbull requirements. It also states that it is evidence which can be relied upon in making this Statement on Internal Control. In addition, the Treasury are provided with quarterly management reports on risk issues and the Bank's compliance with the guidance issued by the Turnbull Report. These reports highlight the Bank's role in identifying, assessing, managing and monitoring the risks relating to its management of the EEA. This process is supported by an Operational Risk Officer in the Foreign Exchange Division, the Risk Management division and, with specific responsibility for the co-ordination of the quarterly reporting framework, the Markets Strategy and Risk Operations Division.

- EFA considers and discusses the information provided with the Bank and Exchequer Funds Internal Audit and provides the Accounting Officer with quarterly reports that highlight the key risks.
- The Bank's Internal Audit Division conducts an agreed internal audit programme as part of the SLA. The Bank's Executive Director for Markets forwards the Internal Audit quarterly reports on this activity to the Accounting Officer.
- Exchequer Funds Internal Audit provides an independent and objective opinion to the Accounting Officer on risk management, control and governance of the EEA. Assurance is provided following reviews of relevant Bank Internal Audit reports and EFA's oversight of the Bank's work, as agreed by the Accounting Officer and the Treasury Group Audit Committee (formerly the Exchequer Funds Audit Committee). Exchequer Funds Internal Audit's reviews aim to measure and evaluate the effectiveness of the Treasury in achieving its agreed objectives in respect of the EEA. Exchequer Funds Internal Audit also reviews EFA's quarterly report to the Accounting Officer (mentioned above).
- Bank and Treasury officials met quarterly to review performance against the parameters set out in the SLA and to consider wider operational and policy issues. Additionally the Accounting Officer and the Bank's Executive Director for Markets held half-yearly meetings to discuss overall strategy and governance issues.
- Bank accountancy professionals produce the financial accounts on behalf of the Treasury using Bank IT systems. EFA liaises with the Bank and DRM to produce the annual accounts. The Treasury Accountant in EFA reviewed and approved the 2010-11 financial accounts and the Foreword to the accounts in draft before I formally approved them.
- The Treasury undertook co-ordinated contingency site tests with the Bank in 2010-11.

4.4 The Treasury Audit Committee is tasked with supporting the Principal Accounting Officer, and the Treasury's Additional and other Accounting Officers in their responsibilities for managing risk, internal control and governance related to the:

- Treasury Group's Departmental Annual Report and Accounts;
- Consolidated Fund;
- Contingencies Fund;
- National Loans Fund; and,
- Exchange Equalisation Account.

Members of the Committee are appointed by the Permanent Secretary for periods up to three years, extendable by no more than two additional three-year periods. The Chair of the Committee reports directly to the Permanent Secretary and presents a regular report to the Treasury Board. The membership of the Committee during 2010-11 was:

- Michael O'Higgins (Chair) – Non Executive Board Member, HM Treasury; Chairman of the Audit Commission; Chairman of the Pensions Regulator; Non Executive Director, Investec-Calculus Venture Capital Trust;
- Mike Ashley[6] - Head of Quality and Risk Management, KPMG Europe LLP; Board Member, KPMG Europe LLP;

[6] Michael Ashley is the KPMG audit partner responsible for the Bank of England's audit. He does not receive Committee papers on the EEA and is required to withdraw from Committee meetings before EEA agenda items are discussed.

- Zenna Atkins - Chief Executive Officer, Wey Education PLC; Managing Director, Zail Enterprises Ltd; Chair, Royal Navy Audit Committee; Non Executive Director, Royal Navy Board;
- Janet Baker – Non Executive Director and Commissioner, Audit Commission; Non Executive Director, Defence Support Group, MoD; Non Executive Director, Rural Payments Agency;
- Bradley Fried - Managing Partner, Grovepoint Capital LLP; Non Executive Director of the Group Board, Investec plc and former CEO, Investec Bank plc; and
- Avinash Persaud - Chairman, Intelligence Capital.

The Treasury Audit Committee has a robust Conflicts of Interest Policy, which requires members to excuse themselves from discussions where potential conflicts may occur. Members are required to inform the Permanent Secretary about any potential conflicts and highlight these at the start of each meeting as appropriate.

In addition to the independent members, the appropriate Accounting Officers, HM Treasury's Group Director of Finance, the Chief Executives of Debt Management Office and the Asset Protection Agency, and the Treasury Accountant also attend Committee meeting as required. Members have the opportunity for a pre-committee discussion with the National Audit Office, Group Head of Internal Audit for HM Treasury and Head of Internal Audit for the Exchequer Funds.

The Treasury Audit Committee met four times during 2010-11.

5. Review of effectiveness

5.1 As Accounting Officer, I have responsibility for reviewing the effectiveness of the system of internal control. My review is informed by the work of Exchequer Funds Internal Audit and Bank Internal Audit, who both provided positive assurance as to the management and control of the EEA in 2010-11 and the executive managers within DRM, EFA and in the Bank, who have responsibility for the development and maintenance of the internal control framework, as well as comments made by external auditors in their management letter and other reports. I have been supported by the Treasury Audit Committee and risk owners in addressing weaknesses and ensuring continuous improvement of the system is in place.

The Treasury Audit Committee considered the 2010-11 accounts in draft and provided me with its views before I formally signed the accounts. In my opinion, the system of internal control was effective with no significant control events identified in 2010-11.

David Ramsden HM Treasury
Accounting Officer 12 July 2011

THE CERTIFICATE AND REPORT OF THE COMPTROLLER AND AUDITOR GENERAL TO THE HOUSES OF PARLIAMENT

I certify that I have audited the financial statements of the Exchange Equalisation Account for the year ended 31 March 2011 under the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000). These comprise the Statement of Comprehensive Income, the Statement of Financial Position, the Statement of Cash Flows and the related notes. These financial statements have been prepared under the accounting policies set out within them.

Respective responsibilities of the Treasury, Accounting Officer and auditor

As explained more fully in the Statement of the Accounting Officer's Responsibilities, the Treasury and Accounting Officer is responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. My responsibility is to audit, certify and report on the financial statements in accordance with the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000). I conducted my audit in accordance with International Standards on Auditing (UK and Ireland). Those standards require me and my staff to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Exchange Equalisation Account's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made in respect of the Exchange Equalisation Account; and the overall presentation of the financial statements. In addition, I read all the financial and non-financial information in the Foreword, the Reconciliation of EEA Statement of Financial Position to IMF Reserves Template, the Statement of the Accounting Officer's Responsibilities and the Statement on Internal Control to identify material inconsistencies with the audited financial statements. If I become aware of any apparent material misstatements or inconsistencies I consider the implications for my certificate.

In addition, I am required to obtain evidence sufficient to give reasonable assurance that the expenditure and income reported in the financial statements have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

Opinion on Regularity

In my opinion, in all material respects the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

Opinion on Financial Statements

In my opinion:

the financial statements give a true and fair view of the state of the Exchange Equalisation

Account's affairs as at 31 March 2011 and of its total comprehensive income and cash flows for the year then ended; and

the financial statements have been properly prepared in accordance with the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000) and HM Treasury directions issued thereunder.

Opinion on other matters

In my opinion the information given in the Foreword for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which I report by exception

I have nothing to report in respect of the following matters which I report to you if, in my opinion:

- adequate accounting records have not been kept; or
- the financial statements are not in agreement with the accounting records or returns; or
- I have not received all of the information and explanations I require for my audit; or
- the Statement on Internal Control does not reflect compliance with HM Treasury's guidance.

Report

I have no observations to make on these financial statements.

Amyas C E Morse
Comptroller and Auditor General
National Audit Office
157-197 Buckingham Palace Road
Victoria
London
SW1W 9SP

14 July 2011

Statement of Comprehensive Income

For the year ended 31 March 2011:

	Note	2011 £ millions	*2010* *£ millions* *Restated*
Interest receivable and similar income	2	846	*916*
Interest payable	3	(452)	*(474)*
Net interest income		**394**	***442***
Fair value changes in gold		1,620	*957*
Fair value changes in financial instruments	4	(242)	*(428)*
Management charge	5	(8)	*(9)*
Total comprehensive income for the year	17	**1,764**	***962***

Statement of Financial Position

	Note	31 March 2011 £ millions	*31 March 2010 £ millions*
Assets			
Cash and balances at central banks and the Government Banking Service	19	1,512	*553*
Items in the course of collection from banks		672	*783*
Treasury bills	6	488	*132*
Debt securities	7	29,162	*23,885*
Derivative financial assets	8	782	*863*
Reverse repurchase agreements	9	2,102	*4,001*
Holdings of IMF Special Drawing Rights	16	9,202	*9,158*
Gold	10	8,954	*7,334*
Other financial assets	11	254	*105*
Total assets		**53,128**	***46,814***
Liabilities			
Deposits by banks	12	57	*36*
Items in the course of transmission to banks		597	*1,008*
Debt securities - short positions	13	889	*632*
Derivative financial liabilities	14	1,165	*1,890*
Repurchase agreements	15	3,223	*2,907*
Other financial liabilities		16	*4*
SDR allocation	16	10,024	*10,144*
Liability to the National Loans Fund	17	37,157	*30,193*
Total liabilities		**53,128**	***46,814***

The notes on pages 24 to 44 form an integral part of these accounts.

David Ramsden
Accounting Officer

HM Treasury
12 July 2011

Statement of Cash Flows

For the year ended 31 March 2011:

	Note	2011 £ millions	*2010* *£ millions*
Net cash outflow from operating activities	18	**(3,502)**	***(3,525)***
Net cash flows from financing activities:			
Cash inflow from National Loans Fund	17	6,550	*5,600*
Cash outflow to National Loans Fund	17	(1,350)	*(2,400)*
Capital repayments	17	-	*(55)*
Net cash inflow from financing activities		**5,200**	***3,145***
Net increase / (decrease) in cash and cash equivalents during the year	19	**1,698**	***(380)***
Cash and cash equivalents at the beginning of the year	19	559	*939*
Cash and cash equivalents at the end of the year	19	**2,257**	***559***

Notes to the Accounts

1 Accounting policies

Basis of preparation

These accounts have been prepared in accordance with the Accounts Direction, reproduced in the Annex to this report, and according to International Financial Reporting Standards (IFRS) as adapted or interpreted for the public sector context. Where the relevant version of the Government Financial Reporting Manual (FReM) permits a choice of accounting policy, the accounting policy which is judged to be most appropriate to the particular circumstances of the EEA for the purpose of giving a true and fair view has been selected. The particular policies adopted by the Treasury for the EEA are described below. They have been applied consistently in dealing with items that are considered material to the accounts.

These accounts are prepared under the historical cost convention on a trade date basis and all assets and liabilities are recognised on their trade dates. The Exchange Equalisation Account is stated in millions of pounds sterling (£m).

At 31 March 2011, a number of standards and interpretations and amendments thereto, had been issued by the IASB which are not yet effective for the EEA's financial statements. Those which are expected to have an effect on the EEA are discussed below.

IFRS 9 'Financial Instruments', which was issued in November 2009, introduced new requirements for the classification and measurement of financial assets. In October 2010, the IASB issued additions to IFRS 9 relating to financial liabilities. Together, these changes represent the first phase in the IASB's planned replacement of IAS 39 'Financial Instruments: Recognition and Measurement'. The standard is effective for annual periods beginning on or after 1 January 2013 with early adoption permitted. IFRS 9 is subject to EU endorsement, the timing of which is uncertain. Accordingly, the EEA is unable to provide a date by which it intends to apply IFRS 9.

IFRS 9 is still subject to change and, as a result, the impact of the standard upon the financial statements of the EEA cannot be quantified.

The revision to IAS 24 'Related Party Disclosures' has been adopted early in line with the FReM. It has not had an impact on the financial statements of the EEA.

In March 2010 amendments were issued to IFRS 7 'Financial Instruments: Disclosures". The amendments are effective for annual periods beginning on or after 1 January 2011 and will affect the EEA's credit risk disclosures in 2011-12.

Change in accounting policy

The FReM no longer requires the EEA to include a notional sterling capital charge within the Statement of Comprehensive Income, which has therefore been restated. The charge of £22m in 2009-10 has therefore been added back. This charge was intended to reflect an assumed cost of capital used by the EEA. Although included within the Statement of Comprehensive Income, it was subsequently added back to the Accumulated Comprehensive Income Reserve. Consequently, the Statement of Financial Position was not previously affected by the notional sterling capital charge, and as a result, has not been restated.

Recognition of financial assets and financial liabilities

The EEA is managed on a homogeneous basis and, although the reserves are not held primarily to make a profit, the Treasury seeks to minimise the cost of holding the foreign currency reserves whilst avoiding exposing the public purse to unnecessary risk. The Bank actively manages the EEA portfolio against the benchmark to meet the active management return set by the Treasury. As a result, the financial assets and liabilities of the EEA are all "held for trading", in accordance with the definition of IAS 39, and therefore all financial assets and liabilities are held at fair value with gains and losses being taken through the Statement of Comprehensive Income. There have been no reclassifications of financial instruments during the year. Financial assets are derecognised when the rights to receive cash flows from them have expired or where the EEA has transferred substantially all the risks and rewards of ownership. Financial liabilities are derecognised when they are extinguished, that is, when the obligation is discharged, cancelled or expires.

Details are given below of the methodologies used to revalue different instrument classes.

Interest receivable and payable

Interest receivable and payable on financial instruments that are held for trading is accrued on a straight line basis.

Special Drawing Rights (SDR) remuneration

The EEA is remunerated (in SDRs) on its holdings of SDRs. This income is included within interest receivable. Remuneration (in SDRs) on loans to the IMF, both the UK's Reserve Tranche Position (RTP) and any lending under the NAB (NLF assets), is also received by the EEA and is recognised in these accounts as interest receivable. Interest is paid on the EEA's SDR Allocation. All SDR remuneration is accounted for on an accruals basis.

Fair value changes in financial instruments

Fair value changes in financial instruments comprises all changes in the fair value of the EEA financial assets and liabilities, excluding interest payable and receivable, which is disclosed separately. Realised gains and losses on disposal or maturity are also included.

Foreign currency translation

Transactions denominated in foreign currencies are recorded in sterling using the rate prevailing at the date of the transaction. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation of monetary assets and liabilities at the Statement of Financial Position date are recognised in the Statement of Comprehensive Income within fair value changes in financial instruments.

Fees and commissions

Fees and commissions are not material and are recognised in the Statement of Comprehensive Income as incurred.

Cash and cash equivalents

For the purpose of the Statement of Cash Flows, cash comprises balances at the Government Banking Service and balances at central banks. Cash equivalents comprise highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value. Such investments normally have maturities of less than three months from the date of acquisition and include settlement balances, treasury bills, and loans and advances to banks. Repos and reverse repos are excluded from cash and cash equivalents.

Items in course of collection from or transmission to other banks

Treasury bills, debt securities, loans and advances to banks, reverse repos, deposits by banks, debt securities - short positions and repos are recorded on a trade date basis. For these financial assets and liabilities, between trade date and settlement date, any amounts payable to or receivable from bank counterparties are recorded separately on the Statement of Financial Position, within items in the course of collection from banks or items in the course of transmission to banks, until settlement occurs.

Debt securities (including short positions)

All debt securities are reported at fair value. Debt securities are initially recognised at cost, as the best estimate of fair value and are subsequently revalued to their market price daily. Changes in the fair value of debt securities are recognised in the Statement of Comprehensive Income, within fair value changes in financial instruments, when they arise.

The majority of bonds are valued directly by reference to published price quotations at 31 March 2011. Other bonds and certificates of deposit are valued using a discounted cash flow valuation technique. All inputs into this pricing model are externally sourced and assumptions used are supported by observable market prices. Bonds and certificates of deposit are priced at bid prices.

Treasury bills

Treasury bills are reported at fair value. Treasury bills are initially recognised at cost, as the best estimate of fair value and are subsequently revalued to their market price daily. Changes in the fair value of treasury bills are recognised in the Statement of Comprehensive Income, within fair value changes in financial instruments, when they arise.

Fair values are either determined by reference to quoted market prices, or by using internal models where no market price is readily obtainable. All inputs into the pricing models are externally sourced and assumptions used are supported by observable market prices.

Loans and advances to banks

Loans and advances are initially recorded at the cost of funds advanced and are then revalued using a discounted cash flow valuation technique. All inputs into the pricing model are externally sourced and assumptions used are supported by observable market prices. Loans and advances are marked to bid prices. Changes in the fair value of loans and advances are recognised in the Statement of Comprehensive Income, within fair value changes in financial instruments, when they arise.

Repurchase (repo) and reverse repurchase (reverse repo) agreements

Securities which have been sold with an agreement to repurchase remain on the Statement of Financial Position and the sale proceeds are recorded as a repo. Securities acquired in reverse sale and repurchase agreements are not recognised on the Statement of Financial Position and the purchase amount is recorded as a reverse repo. The difference between the sale and repurchase amount is accrued evenly over the life of the transaction and credited or charged to the Statement of Comprehensive Income as interest receivable or payable. Repos and reverse repos are marked to bid or offer prices, as appropriate.

Repurchase and reverse repurchase agreements are initially recognised at cost as the best estimate of fair value and subsequently revalued daily. These are valued using a discounted cash flow valuation technique. All inputs into the pricing model are externally sourced and assumptions used are supported by observable market prices. Changes in the fair value of repos and reverse repos are recognised in the Statement of Comprehensive Income, within fair value changes in financial instruments when they arise.

Gold

Gold and gold assets are treated as being similar to a financial asset and, as such, are reported at fair value. Gold holdings and gold assets on deposit are valued at the sterling equivalent of the London Bullion Market Association (LBMA) dollar denominated spot price as at 31 March 2011. Revaluation gains and losses on gold assets are recognised within fair value changes of gold in the Statement of Comprehensive Income.

International Monetary Fund Special Drawing Rights (SDRs)

SDRs are an international reserve asset created by the IMF. These consist of a weighted basket of the US dollar, euro, yen and sterling. SDR exchange rates are published by the IMF and SDRs are recognised on the statement of financial position at their closing sterling value.

Derivative transactions

Derivative transactions are used to manage risk in the reserves. Such instruments include exchange rate forwards, currency swaps, interest rate swaps and interest rate and bond futures. Derivatives are carried at fair value and changes in the fair values are reported within fair value changes in financial instruments in the Statement of Comprehensive Income. Fair values are either determined by reference to quoted market prices, or by using internal models where no market price is readily obtainable. All inputs into the pricing models are externally sourced and assumptions used are supported by observable market prices. Derivatives are marked to bid or offer prices, as appropriate.

Derivatives with positive fair values are recognised on the Statement of Financial Position within derivative financial assets. Derivatives with negative fair values are included within derivative financial liabilities.

Interest receipts and payments relating to derivative transactions are recognised in the Statement of Comprehensive Income within interest income or interest expense (as appropriate) as they occur.

Collateral and Netting

The EEA enters into master agreements with counterparties and, when appropriate, obtains collateral. A master agreement provides that if an event of default occurs, all outstanding transactions with the counterparty under the agreement will fall due and all amounts outstanding under the agreement will be settled on a net basis.

Collateral is received in the form of cash or securities. Collateral received in the form of securities is not recorded on the Statement of Financial Position. Collateral received in the form of cash is recorded on the Statement of Financial Position with a corresponding liability, assigned to deposits by banks. Any interest arising on collateral received is recorded as interest expense.

Although master netting agreements are in place, the lack of intention to settle on a net basis results in the related assets and liabilities being reported gross in the Statement of Financial Position.

Critical accounting judgements and key sources of estimation uncertainty

The preparation of financial statements in conformity with IFRSs requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the entity's accounting policies.

Management believes that the EEA's critical accounting policies where judgement is necessarily applied are those relating to the valuation of financial instruments where there is no readily available market price, and the valuation of gold. Further information about how financial instruments are valued in such circumstances is provided in the 'Debt securities' and 'Derivative transactions' accounting policies above. At 31 March 2011 there were no valuations which are not supported by observable market prices or rates (*2010: £nil*). Gold and gold assets are treated as being similar to a financial asset and are reported at fair value as described in the 'Gold' accounting policy. The valuation of gold at 31 March 2011 was £8,954m (*2010: £7,334m*).

The financial assets and financial liabilities of the EEA are classified as held for trading, as they all form part of a portfolio that is managed as a whole and for which there is evidence of a recent pattern of short-term profit taking.

2 Interest receivable and similar income

	2011 £ millions	*2010* *£ millions*
Debt securities	721	*776*
Currency swaps	51	*75*
Interest rate swaps	30	*46*
Reverse repurchase agreements	6	*2*
Reserve Tranche Position	8	*4*
Special Drawing Rights	30	*13*
Total	**846**	***916***

3 Interest payable

	2011 £ millions	*2010* *£ millions* *Restated*
Currency swaps	324	*382*
Interest rate swaps	62	*55*
Repurchase agreements	9	*7*
SDR allocation	33	*17*
Interest on short positions in bonds	24	*13*
Total	**452**	***474***

4 Fair value changes in financial instruments

Analysis of fair value gains/(losses) by instrument type	2011 £ millions	*2010* *£ millions*
Currency swaps	333	*570*
Debt securities	(939)	*(1,248)*
Foreign exchange transactions	223	*154*
Futures	(8)	*(3)*
Interest rate swaps	73	*5*
Loans and deposits	7	*2*
Repurchase and reverse repurchase agreements	95	*109*
SDRs	13	*97*
Treasury bills	(39)	*(114)*
Total	**(242)**	***(428)***

5 Management charge

The management charge of £8m represents the cost of the Bank of England's management of the EEA during the year (*2010: £9m*).

6 Treasury bills

	2011 £ millions	*2010* *£ millions*
Maturing in not more than 3 months	435	*132*
Maturing in 1 year or less but over 3 months	53	*–*
Total	**488**	***132***

7 Debt securities

	2011 £ millions	*2010* *£ millions*
Issued by Public Bodies		
Government Securities	27,514	*21,824*
Other Public Sector – Listed	1,234	*1,824*
Other Public Sector – Unlisted	414	*237*
Total	**29,162**	***23,885***

	2011	*2010*
Amounts Maturing:	£ millions	*£ millions*
Current	4,617	*2,837*
Non-current	24,545	*21,048*
Total	**29,162**	***23,885***

8 Derivative financial assets

	2011 £ millions	*2010* *£ millions*
Currency swaps	263	*85*
Interest rate swaps	83	*27*
Foreign exchange transactions	436	*751*
Total	**782**	***863***

9 Reverse repurchase agreements

	2011 £ millions	*2010* *£ millions*
Amounts maturing:		
Current	2,102	*4,001*
Total	**2,102**	***4,001***

Collateral with a carrying value of £2,159m (*2010: £4,060m)* is held in respect of reverse repo transactions. Cash collateral held is recognised within Deposits by Banks (see note 12). Other collateral held is not recognised by the EEA. The EEA is permitted under the terms of its reverse repo transactions to sell debt securities held as collateral. The carrying amount of short positions in debt securities arising as a result of selling collateral held is given in note 13.

10 Gold

	2011 £ millions	*2010* *£ millions*
Gold Stock	8,954	*7,334*
Total	**8,954**	***7,334***

There were no gold deposit trades undertaken during the year *(2010: nil)*. There was no change in the quantity of gold owned by the EEA in 2010-11 (*2010: nil*).

11 Other financial assets

	2011 £ millions	*2010* *£ millions*
Margin accounts	–	*2*
Loans and advances to banks	235	*99*
Prepayments and accrued income	19	*4*
Total	**254**	***105***

12 Deposits by banks

	2011 £ millions	*2010* *£ million*
Amounts maturing:		
Current	57	*36*
Total	**57**	***36***

There were no deposits by banks repayable on demand as at 31 March 2011 (*2010: nil).*

13 Debt securities - short position

	2011 £ millions	*2010* *£ millions*
Debt securities – short positions	889	*632*
Total	**889**	***632***

Short positions in securities relate to the sale of bonds acquired as collateral through reverse repurchase transactions (see note 9). All bonds, in both years, were government or other public sector securities listed overseas, and are expected to mature after 12 months.

14 Derivative financial liabilities

	2011 £ millions	*2010* *£ millions*
Currency swaps	636	*1,100*
Interest rate swaps	22	*37*
Foreign exchange transactions	507	*753*
Total	**1,165**	***1,890***

15 Repurchase transactions

	2011 £ millions	*2010* *£ millions*
Amounts maturing:		
Current	3,223	*2,907*
Total	**3,223**	***2,907***

The EEA pledges collateral to counterparties in repo transactions. Collateral pledged remains on the statement of financial position of the EEA within Debt Securities. The total carrying amount of collateral pledged as at 31 March 2011 was £3,192m (*2010: £2,866m*).

16 SDR allocation and SDR Holdings

The EEA has a liability to the IMF for those SDRs that have been allocated since the UK became a participant in the Special Drawing Rights Agreement. If the UK withdraws from participation or the Agreement is wound up, payment to the IMF would be required at current exchange rates. The SDR liability as at 31 March 2011 was £10,024m *(2010: £10,144m)*.

The SDR holdings of the EEA as at 31 March 2011 was £9,202m (*2010: £9,158m*). These holdings result from SDR allocations made by the IMF and any subsequent purchases and sales of SDRs from or to other IMF members. During 2010-11, the EEA bought £149m worth of SDRs (*2009-10: £633m*).

Further detail on the SDRs is provided in the Foreword.

17 Liability to the National Loans Fund

The net assets of the EEA represent a liability to the NLF. There are two elements of the Liability to the NLF: a specific liability, recognised in accordance with the National Loans Act 1968 of £9,160m (*2010: £3,960m*) that represents the balance of advances made by the NLF and not repaid; and a separate amount that represents the EEA's total assets, less recognised liabilities. This second element consists of the capital contribution reserve and the accumulated income and expenditure reserve.

The EEA is funded by central government through the NLF. Over time, the NLF has advanced sterling to the EEA in order to finance the reserves. Similarly, if the NLF were to issue foreign currency securities in order to raise foreign currency finance that would subsequently be transferred to the EEA. As a result, the EEA's net assets, having been derived from initial NLF financing, are ultimately due to the NLF, and are recognised as such on the statement of financial position. If a policy decision is taken to reduce the assets of the EEA, the sterling excess raised via sale of foreign currency assets would be paid to the NLF, at the direction of the Treasury.

Specific liability to the NLF

The specific element of the liability to the NLF, described in the National Loans Act 1968, is the mechanism through which the EEA's day to day sterling cash flows are managed.

The sterling balance held by the EEA at the Bank of England is maintained within a range, agreed by management. When the balance falls below the minimum level, it can be increased by a fresh issue of capital from the NLF under the terms of section 7 of the National Loans Act 1968. This creates a liability of the EEA to the NLF. Conversely, when foreign currency is sold for sterling with the result that the sterling balance is in excess of the EEA's requirements, the Treasury can decide that some reduction should be made by a transfer from the EEA to the NLF.

If there is no outstanding specific liability to the NLF at the time of a sterling transfer from the EEA to the NLF, then the transfer is treated as a 'capital repayment' and is used to reduce the capital contribution reserve. The effect on the combined liability to the NLF, recognised in the Statement of Financial Position, is identical.

The remainder of the liability to the NLF consists of the capital contribution reserve and the accumulated income & expenditure reserve. These items are described in detail below.

Capital contribution reserve

When UK GAAP compliant accounts were prepared for the first time for the EEA, being for the year ended 31 March 2001, an amount equivalent to the total recognised assets, less liabilities, less the balance on the specific liability to the NLF in the opening statement of financial position of that year, was taken to be the opening balance for the capital contribution reserve. The amount of the capital contribution reserve is periodically reduced, as explained above, because when there is no outstanding specific liability to the NLF, sterling repayments by the EEA to the NLF are taken to the capital contribution reserve.

Accumulated comprehensive income reserve

All gains and losses of the EEA, since UK GAAP compliant accounts were first prepared in 2001, have been taken to the accumulated comprehensive income reserve. Comparative

information has been restated to reflect the change in accounting policy with regard to the notional sterling capital charge as described in note 1.

The following table shows the movements in each of the elements described above, and the overall liability to the NLF, during the year.

All amounts in £ millions	Accumulated comprehensive income reserve	Capital contribution reserve	Specific liability to the NLF	2011 Overall liability to the NLF
Balance at 1 April 2010	16,996	9,237	3,960	30,193
Transfers from the NLF	–	–	6,550	6,550
Repayments to the NLF	–	–	(1,350)	(1,350)
Capital repayments	–	–	–	–
Total comprehensive income	1,764	–	–	1,764
Balance at 31 March 2011	**18,760**	**9,237**	**9,160**	**37,157**

All amounts in £ millions	*Accumulated comprehensive income reserve Restated*	*Capital contribution reserve Restated*	*Specific liability to the NLF Restated*	*2010 Overall liability to the NLF Restated*
Balance at 1 April 2009	*16,034*	*9,292*	*760*	*26,086*
Transfers from the NLF	*–*	*–*	*5,600*	*5,600*
Repayments to the NLF	*–*	*–*	*(2,400)*	*(2,400)*
Capital repayments	*–*	*(55)*	*–*	*(55)*
Total comprehensive income	*962*	*–*	*–*	*962*
Balance at 31 March 2010	***16,996***	***9,237***	***3,960***	***30,193***

18 Reconciliation of Statement of Comprehensive Income to net cash outflow from operating activities

	2011 £ millions	*2010* *£ millions* *Restated*
Total comprehensive income for the year	1,764	*962*
Net (increase)/decrease in treasury bills	(53)	*1,083*
Net (increase)/decrease in debt securities	(5,277)	*261*
Net decrease/(increase) in derivative financial assets	81	*423*
Net (increase) in holding of SDRs	(44)	*(8,857)*
Net (increase) in gold and gold receivables	(1,620)	*(957)*
Net decrease /(increase) in reverse repurchase agreements	1,899	*(3,702)*
Net (increase) in other assets	(13)	*(4)*
Net (decrease)/increase in SDR allocation	(120)	*8,148*
Net increase in debt securities - short positions	257	*373*
Net increase/(decrease) on deposits by banks	21	*(4)*
Net (decrease) in derivative financial liabilities	(725)	*(2,253)*
Net increase in repurchase agreements	316	*1,000*
Net increase in other financial liabilities	12	*2*
Net cash (outflow) from operating activities	**(3,502)**	***(3,525)***

19 Cash and cash equivalents

	1 April 2010 £ millions	Cash flow £ millions	31 March 2011 £ millions
Balance at the Government Banking Service	250	(250)	–
Balances at Central Banks	303	1,209	1,512
	553	959	1,512
Amounts with original maturity less than 3 months:			
Items in the course of collection from banks	783	(111)	672
Treasury bills	132	303	435
Other financial assets	99	136	235
Items in the course of transmission to banks	(1,008)	411	(597)
	6	739	745
Total	**559**	**1,698**	**2,257**

	1 April 2009 £ millions	*Cash flow £ millions*	*31 March 2010 £ millions*
Balance at the Government Banking Service	*31*	*219*	*250*
Balances at Central Banks	*404*	*(101)*	*303*
	435	*118*	*553*
Amounts with original maturity less than 3 months:			
Items in the course of collection from banks	*231*	*552*	*783*
Treasury bills	*523*	*(391)*	*132*
Other financial assets	*3*	*96*	*99*
Items in the course of transmission to banks	*(253)*	*(755)*	*(1,008)*
	504	*(498)*	*6*
Total	***939***	***(380)***	***559***

20 Related Party Transactions

The Royal Bank of Scotland Group plc is regarded as a related party of the EEA. On 1 December 2008, the UK Government, through HM Treasury[6], became the ultimate controlling party of The Royal Bank of Scotland Group plc. During the year the EEA entered into various transactions with The Royal Bank of Scotland Group plc, which were all conducted on an arm's length basis and were part of the EEA's normal activity. At 31 March 2011 balances with The Royal Bank of Scotland Group plc were:

	2011 £ millions	*2010 £ millions Restated*
Derivative assets	2	*102*
Derivative liabilities	(58)	*(114)*
Reverse Repos	60	-
Repos	(91)	-

The UK Government, through HM Treasury[7], owns 41% of the ordinary share capital of the Lloyds Banking Group. As a result, the Lloyds Banking Group is a related party of the EEA. During the year the EEA entered into various transactions with the Lloyds Banking Group, which were all conducted on an arm's length basis and were part of the EEA's normal activity. There were no balances outstanding at 31 March 2011 *(31 March 2010: nil)*.

During the year, the EEA has not entered into transactions with any other financial institutions in which the UK Government has an investment.

The EEA has provided foreign currency services for a number of government departments and agencies during the year.

[7] Details of HM Treasury's holdings can be found on its website at www.hm-treasury.gov.uk.

The 31 March 2010 balances have been restated. Previously currency swaps were included in this note on a gross basis. It is considered that it is more appropriate to reflect these balances on a net basis, in line with how they are presented in the Statement of Financial Position. This has resulted in decreases in the related party balances with Royal Bank of Scotland Group plc as at 31 March 2010, of £22m in derivative assets (from £125 million) and £293 million in derivative liabilities (from £407 million). This has had no impact on the Statement of Financial Position.

21 Risk management and control

A detailed review of the risks to which the EEA is exposed, how these risks arise and how they are managed is given in the Foreword. The Foreword also details management's objectives and policies for managing risks.

Quantitative data is given below in respect of the financial risks faced by the EEA, the most relevant of which are considered to be market and credit risk. In each case, the data provided reflects the year-end position unless stated otherwise.

Derivative transactions entered into by the EEA are documented under Master Legal Agreements with counterparties. Swaps transactions are governed by the ISDA Master Agreement. Foreign exchange transactions are governed either by the ISDA Master Agreement or by the BBA International Foreign Exchange Master Agreement (IFEMA). Repo and reverse repo transactions are governed by bespoke documentation.

Market risk

Market risk is the risk arising from exposure to movement on market variables. The main market variables to which the EEA is exposed are interest rates and exchange rates. The risks arising from each of these factors, and how those risks are managed, are detailed below. Further details are also provided in the Foreword.

All benchmarks for the reserves are determined by the Treasury, and are in line with the EEA's policy objectives. Market risk is taken into account when determining the benchmark (see Benchmark allocations section in the Foreword).

VaR is the primary market risk management tool employed in relation to the active management of the EEA against the benchmarks. A summary of the method of calculation of VaR is given in the Foreword in paragraphs 54 and 55. Active management usage of VaR during the year, (calculated at the close of business each day in US dollars), was as follows:

	$ millions 2011	*$ millions 2010*
VaR usage as at 31 March	1.75	*3.23*
Average usage during the year	2.50	*4.10*
Maximum VaR usage during the year	5.17	*5.28*
Minimum VaR usage during the year	1.16	*2.86*
VaR limit during the year	20.00	*20.00*

The minimum VaR usage is the higher of unweighted and exponentially weighted, which for 2010-11 was unweighted (*2009-10: unweighted*).

Interest rate risk

Methods employed for hedging interest rate risk in the benchmarks are described in detail in the Foreword. The majority of the assets and liabilities of the EEA, after taking account of the effect of derivatives that alter the interest rate risk profile of instruments, are floating rate.

Foreign exchange risk

As explained in the Foreword, the official reserves (i.e. reserves of the EEA plus those foreign currency assets and liabilities of the NLF that are managed together with the EEA) can be divided into two categories; the reserves that are hedged for foreign exchange and interest rate risk (the 'hedged' reserves), and those reserves that are not hedged for foreign exchange and interest rate risk (the 'unhedged' reserves).

Assets and liabilities in the hedged reserves are funded by either sterling swapped into foreign currency, via asset swap packages, or through foreign currency issuances on the NLF. In either of these cases, the future cash flows from the assets invested in are swapped back into the currency and interest rate profile of the originating liability. Any residual foreign exchange risk is immaterial.

Assets and liabilities in the unhedged reserves are held in a benchmark foreign currency allocation of 40% US dollar, 40% Euro, and 20% Yen. This is a structural benchmark position and reflects Treasury investment policy. Further detail on the policy processes for determining benchmark asset allocations is given in the Foreword.

An analysis of EEA unhedged reserves by currency is provided in the tables below.

	2011	*2010*
	£ millions	*£ millions*
US Dollar	5,346	*5,260*
Euro	5,338	*5,258*
Yen	2,454	*2,611*
Other Currencies	4	*4*
	13,142	*13,133*
SDR	(822)	*(986)*
Gold	8,954	*7,336*
EEA Net Reserves	**21,274**	***19,483***

Credit risk

The reserves are exposed to credit risk through exposures to trading counterparties and to the issuers of securities. Details of the risk management processes undertaken to limit this exposure to credit risk, and to ensure the creditworthiness of counterparties and issuers, are provided in the Foreword.

The EEA continued to invest in high credit quality assets throughout the year. Foreign currency assets held in the EEA inevitably carry some element of credit risk. In order to keep this risk at a low level, the funds of the EEA are predominantly invested in securities issued, or guaranteed by the national governments of the United States, euro-zone countries and

Japan. The majority of the EEA funds are invested in high quality sovereign or supranational bonds.

Regular credit assessments are performed on all market counterparties and issuers to which the EEA may be exposed. These are performed both regularly, following a timetable that reflects the risk of the actual or potential exposure, and dynamically, in response to market or specific entity conditions.

The EEA's Credit Ratings Advisory Committee (CRAC), chaired by the Head of the Bank of England's Risk Management Division, reviews regularly the creditworthiness of issuers, counterparties and customers to whom the EEA may have credit exposures. CRAC makes recommendations to the Executive Director for Markets, who is responsible for decisions on internal credit ratings. CRAC is supported by a credit risk analysis team.

Credit risk is controlled by counterparty and issuer limits and collateralisation. Exposure to issuers and counterparties is monitored against limits in real time. Counterparty credit limits are set in terms of "Credit Equivalent Amounts". In the case of derivatives contracts, exposure is measured as the marked-to-market value plus an estimate of the potential future exposure calculated using a parametric approach and volatility and correlation data. Limits are set for both individual entities and groups of related entities, and on certain instruments traded. In addition, there are limits to contain the overall exposure to each relevant country's banking sector. Limits are also set on the maturity of repo and foreign exchange transactions with counterparties. Any limit excesses are reported to the Treasury each month.

Concentration of Exposure

Concentration of credit risk arises when a number of issuers or counterparties have comparable economic characteristics, or are engaged in similar activities or operate in the same geographical areas, so that their collective ability to meet contractual obligations is similarly affected by changes in economic, political or other conditions.

Concentration of EEA assets by geographical region.

	2011	*2010*
	£ millions	*£ millions*
United Kingdom	2,197	*668*
North America	13,520	*11,620*
Europe	16,141	*14,354*
Asia-Pacific	3,114	*3,653*
Rest of the World	–	*27*
	34,972	*30,322*
IMF SDRs	9,202	*9,158*
Gold	8,954	*7,334*
Total Assets	**53,128**	***46,814***

Concentration of EEA assets by credit rating.

	£ millions	*£ millions*
AAA	26,642	*22,750*
AA	7,436	*6,628*
A	752	*749*
BBB	–	*195*
BB	142	*–*
	34,972	*30,322*
IMF SDRs	9,202	*9,158*
Gold	8,954	*7,334*
Total Assets	**53,128**	***46,814***

The above table reflects an average rating from the three rating agencies, set out in paragraph 14 of the Foreword. None of the EEA's financial assets are past due or impaired.

At 31 March 2011, credit exposures to issuers stood at £28,762m *(2010: £23,329m).*

Other risk mitigation policies

In addition to the use of credit limits, exposure to credit risk is managed through other mitigation measures, as outlined below:

a) Netting agreements

The EEA's exposure to credit losses in respect of derivative financial instruments is restricted by entering into netting arrangements under master agreements with counterparties that allow the EEA to net transactions under the master agreement in the event of a counterparty default. These agreements incorporate terms for provision of collateral, including provision for additional margin to be called in response to changes in market values of underlying transactions.

b) Collateral

For funds advanced under reverse repo, the EEA takes collateral in the form of high quality securities, which must be of a type that the EEA is authorised to hold as an investment.

For interest rate and cross currency swaps and forward foreign exchange transactions transacted under ISDA Master Agreements, collateral can take the form of US dollar denominated cash or high quality securities.

At 31 March 2011, net credit exposure to counterparties including potential future exposure stood at £1,184m *(2010: £293m)*. Collateral of £5,453m *(2010: £7,072m)* was held. All collateral was readily convertible into cash. The EEA is fully collateralised within its margin arrangements.

c) Settlement processes

Wherever possible, trades are settled as Delivery versus Payment, with simultaneous exchange of cash and stock, or settlement whereby the EEA receives cash or stock from the

counterparty before delivering stock or cash in return. Settlement limits are used to control FX settlement risk.

Liquidity risk

The funding structure of the EEA and the EEA's relationship with the NLF is described in detail in the Foreword. As described there, the NLF provides sterling funding to the EEA when required, and therefore the EEA, as an individual entity, is not exposed to sterling liquidity risk.

The EEA maintains a sterling account with the NLF that is used as the mechanism via which funding is transferred to the EEA, and excess cash is repaid to the NLF. This account is monitored daily and is maintained within a range. Forward looking cash flow forecasts are used to predict likely demand for cash in the EEA. Requests for funding from the NLF, and for repayments to be made, are processed when the account is forecasted to fall below, or to exceed, the range.

Undiscounted contractual cash flows of financial liabilities

The table below presents the cash flows payable by the EEA arising from financial liabilities until their contractual maturity date. The amounts disclosed in the table are the contractual undiscounted cash outflows, whereas amounts are presented in the Statement of Financial Position at their carrying values, as detailed in note 1 – Accounting policies.

The maturity analysis for derivative financial liabilities includes both known cash flows and cash flows predicted by current forward rates for the floating leg of currency and interest rate swaps.

As at 31 March 2011: All amounts in £ millions	**Up to 1 month**	**1 to 3 months**	**3 to 12 months**	**1 to 5 years**	**More than 5 years**	**Undated**	**Total**
Deposits by banks	(57)	–	–	–	–	–	(57)
Items in the course of transmission to banks	(597)	–	–	–	–	–	(597)
Debt securities – short positions	(889)	–	–	–	–	–	(889)
Derivative financial liabilities – inflows	2,333	3,527	5,777	9,514	2	–	21,153
Derivative financial liabilities – outflows	(2,406)	(3,691)	(6,438)	(10,000)	(2)	–	(22,537)
Repurchase agreements	(2,615)	(584)	(24)	–	–	–	(3,223)
Other financial liabilities	(16)	–	–	–	–	–	(16)
SDR Allocation	–	–	–	–	–	(10,024)	(10,024)
Liability to the NLF	–	–	–	–	–	(37,157)	(37,157)
Total	**(4,247)**	**(748)**	**(685)**	**(486)**	**–**	**(47,181)**	**(53,347)**

As at 31 March 2010: All amounts in £ millions	***Up to 1 month***	***1 to 3 months***	***3 to 12 months***	***1 to 5 years***	***Undated***	***Total***
Deposits by banks	*(36)*	–	–	–	–	*(36)*
Items in the course of transmission to banks	*(1,008)*	–	–	–	–	*(1,008)*
Debt securities – short positions	*(632)*	–	–	–	–	*(632)*
Derivative financial liabilities – inflows	*1,654*	*3,505*	*4,225*	*9,022*	–	*18,406*
Derivative financial liabilities – outflows	*(1,742)*	*(3,804)*	*(4,962)*	*(9,765)*	–	*(20,273)*
Repurchase agreements	*(2,364)*	*(434)*	*(105)*	–	–	*(2,903)*
Other financial liabilities	*(4)*	–	–	–	–	*(4)*
SDR Allocation	–	–	–	–	*(10,144)*	*(10,144)*
Liability to the NLF	–	–	–	–	*(30,193)*	*(30,193)*
Total	***(4,132)***	***(733)***	***(842)***	***(743)***	***(40,337)***	***(46,787)***

Derivatives

The EEA uses derivatives to manage its exposure to interest rate and exchange rate risks. A description of the use of derivatives is given in the Foreword. All derivative instruments are held at their fair values. Fair values are determined by reference to market rates prevailing on the date of valuation or by discounting future cash flows. The notional principal amounts of these instruments indicate the volume of transactions outstanding as at 31 March 2011 and are not a representation of the amount of risk.

Notional principal amounts and fair values of trading instruments entered into with third parties were as follows:

All amounts in £ millions

	2011			*2010*		
	Notional Principal Amounts	Fair values Assets	Fair values Liabilities	*Notional Principal Amounts*	*Fair values Assets*	*Fair values Liabilities*
Exchange rate contracts:						
Spot and forwards	23,374	436	(507)	*23,548*	*751*	*(753)*
Currency swaps	14,783	263	(636)	*8,742*	*85*	*(1,100)*
	38,157	699	(1,143)	*32,290*	*836*	*(1,853)*
Interest rate contracts:						
Interest rate swaps	5,757	83	(22)	*1,739*	*27*	*(37)*
Interest rate futures	2,552	–	–	*3,295*	–	–
	8,309	83	(22)	*5,034*	*27*	*(37)*
Total	**46,466**	**782**	**(1,165)**	***37,324***	***863***	***(1,890)***

At 31 March 2011, in cases where the EEA had a net exposure to financial institutions on derivative positions, after taking account of netting, where ISDA netting Master Agreements

permit, the exposure was £131m (*2010: £92m*). Net of collateral held, the exposure was £72m (*2010: £56m*).

22 Fair Value Valuation Basis

The table below provides an analysis of the various bases described in the notes which have been deployed for valuing the financial instruments measured at fair value in the financial statements.

During the financial year no financial instruments were measured at fair value with significant unobservable inputs (*2010: nil*). There were no significant transfers between Level 1 and Level 2 of the fair value hierarchy.

The valuations of financial instruments have been classified into three levels according to the quality and reliability of information used to determine the fair values.

Level 1 – quoted market price: financial instruments with quoted prices for identical instruments in active markets.

Level 2 – valuation technique using observable inputs: financial instruments with quoted prices for similar instruments or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.

Level 3 – valuation technique with significant unobservable inputs: financial instruments valued using valuation techniques where one or more significant inputs are unobservable.

As at 31 March 2011	Quoted market price	Using observable inputs	With significant unobservable inputs	Total
	Level 1	Level 2	Level 3	
Assets	£ millions	£ millions	£ millions	£ millions
Treasury bills	–	488	–	488
Debt securities	29,162	-	–	29,162
Derivative financial assets	–	782	–	782
Reverse repurchase agreements	–	2,102	–	2,102
Holdings of IMF Special Drawing Rights	9,202	–	–	9,202
Other financial assets	–	235	–	235
Total assets	**38,364**	**3,607**	**–**	**41,971**
Liabilities				
Debt securities – short positions	889	–	–	889
Derivative financial liabilities	–	1,165	–	1,165
Repurchase agreements	–	3,223	–	3,223
SDR allocation	10,024	–	–	10,024
Total liabilities	**10,913**	**4,388**	**–**	**15,301**

As at 31 March 2010	*Quoted market price*	*Using observable inputs*	*With significant unobservable inputs*	*Total*
	Level 1	*Level 2*	*Level 3*	
Assets	*£ millions*	*£ millions*	*£ millions*	*£ millions*
Treasury bills	*–*	*132*	*–*	*132*
Debt securities	*23,863*	*22*	*–*	*23,885*
Derivative financial assets	*–*	*863*	*–*	*863*
Reverse repurchase agreements	*–*	*4,001*	*–*	*4,001*
Holdings of IMF Special Drawing Rights	*9,158*	*–*	*–*	*9,158*
Other financial assets	*–*	*99*	*–*	*99*
Total assets	***33,021***	***5,117***	*–*	***38,138***
Liabilities				
Debt securities – short positions	*632*	*–*	*–*	*632*
Derivative financial liabilities	*–*	*1,890*	*–*	*1,890*
Repurchase agreements	*–*	*2,907*	*–*	*2,907*
SDR allocation	*10,144*	*–*	*–*	*10,144*
Total liabilities	***10,776***	***4,797***	*–*	***15,573***

23 Date of Authorisation for Issue of Account

The Account was authorised for issue on 14 July 2011.

ANNEX A

ACCOUNTS DIRECTION GIVEN BY HM TREASURY UNDER THE EXCHANGE EQUALISATION ACCOUNT ACT 1979[8]

1. This direction applies to the Exchange Equalisation Account.

2. The Treasury shall prepare accounts for the Exchange Equalisation Account ("the Account") for the year ending 31 March 2011 and each subsequent financial year, which give a true and fair view of the state of affairs of the Account at the reporting date, and of its income and expenditure and cash flows for the year then ended.

3. The accounts shall be prepared in accordance with the requirements of the relevant version of the Government Financial Reporting Manual (FReM).

4. The accounts shall present a Statement of Comprehensive Income, a Statement of Financial Position and a Statement of Cash Flows. The Statement of Financial Position shall present assets and liabilities in order of liquidity.

5. The notes to the accounts shall include disclosure of assets and liabilities, and of income and expenditure, relating to other central government funds, including the National Loans Fund, and shall also include disclosure of management costs.

6. The report shall include:

    (i) a brief history of the Account, and its statutory background;
    (ii) an outline of the scope of the Account, its relationship to HM Treasury and other central funds, and its management operations;
    (iii) a management commentary including appropriate information on financial performance and position reflecting the relationship between the Account and other central funds;
    (iv) a statement on internal control.

7. This Accounts Direction shall be reproduced as an appendix to the accounts.

8. This Accounts Direction supersedes that issued on 5 March 2009.

Chris Wobshall
Head, Assurance and Financial Reporting Policy
HM Treasury
17 March 2010

[8] As amended by the Finance Act 2000

Glossary

Active management is the difference between actual returns and the returns which would have been achieved from a passive investment strategy (see "Benchmark" below).

Basis point (bp) is equal to 100th of a percentage point, e.g. 0.5% is equal to 50bp.

Benchmark is the neutral or passive investment strategy for the reserve portfolio. Active management performance is measured against a target return over the benchmark.

Certificate of deposit is a savings certificate entitling the holder to receive interest.

Corporate commercial paper is a short–term debt issued by companies.

Credit risk is the risk of financial loss arising from counterparty to a transaction defaulting on its financial obligations under that transaction.

Currency risk is the risk of financial loss arising from fluctuations in exchange rates.

Custodian is a bank or other financial institution that keeps custody of assets of the EEA.

Delta measures the change in the value of a portfolio for each one basis point shift in the relevant yield curve.

Derivatives are a collective name for contracts whose value is derived from the prices of another (underlying) investment. For the EEA, the main derivatives are futures, forwards and swaps.

Discount note is a short–term debt instrument issued at a discount to its face value.

Euro area is the area of 16 nations which have adopted the euro as a single currency.

Floating rate note is a debt instrument that pays a variable interest rate.

Foreign currency reserves consists of bonds and notes, money market instruments, foreign currency and deposits, less unsettled trades and excluding the market valuation of foreign currency FX forwards and swaps.

Forward rate agreement – a contract obligating two parties to exchange the difference between two interest rates at some future date; one rate being fixed now and the other being a rate to be fixed in the future.

Forward transaction – an agreement to pay a specific amount at a specific time in the future for a currency or financial instrument.

Futures – a contract to buy or sell a specified asset at a fixed price at some future point in time.

General Agreement to Borrow (GAB) – allows the IMF to borrow specific amounts of currencies from industrialised countries, including the UK, at market related rates of interest.

Government Financial Reporting Manual (FReM) – is the technical accounting guide that complements guidance on the handling of public funds published separately by the relevant authorities.

Hedge – an asset or derivative whose market risk offsets the risk in another asset held or liability. Hedge refers to the economic purpose of an instrument and is not used in the accounting sense to imply the use of hedge accounting.

Hedged reserves refers to that part of the reserves, financed by repo or sterling swapped into foreign currencies or foreign currency securities, on which currency and interest rate exposure is hedged, and reverse repo purchases funded by repo.

Interest rate risk is the risk of financial loss arising from fluctuations in interest rates.

Intervention is the purchase or sale of a currency by central banks or governments with the intention of influencing its market exchange rate.

Liquidity is the ease with which one financial claim can be exchanged for cash as a result of the willingness of third parties to transact in these assets. Liquidity risk is the risk that financial claims can only be turned into cash with a delay or at some cost, or both.

Mark to market – recording the price or fair value of a security, portfolio or account to reflect its current market value rather than its book value.

Market Risk is the risk of financial loss arising from movements in market variables such as in interest rates or exchange rates.

National Loans Fund (NLF) – the account used for most of the Government's borrowing transactions, payments of debt interest and some domestic lending transactions.

New Arrangement to Borrow (NAB) – is a set of credit arrangements between the IMF and 39 member countries and institutions, including the UK. The NAB was extended in March 2011 as a key part of efforts to overcome the global financial crisis. The expanded NAB has tripled the resources available to the IMF from pre-crisis levels.

Operational risk is the risk of financial loss arising from failures in the transaction, settlement and resource management processes associated with reserves and liability management. This broad definition includes risks such as fraud risk, settlement risk, IT risks, legal risk, accounting risk, personnel risk and reputational risk.

Reserve Tranche Position (RTP) is the difference between the IMF's holdings of sterling and the UK's subscription (or quota) to the IMF. In effect, the amount of the UK's subscription the IMF has called. The RTP is a reserve asset as in the event of need, the UK could exchange sterling for useable foreign currencies up to the value of its RTP.

Reserves – refers to the UK holdings of international reserves, reported on a gross basis. Gross reserves consist of foreign currency reserves, IMF position (the RTP and the net SDR position) and gold holdings.

Sale and repurchase agreements (repo) – the sale of an asset with an obligation to repurchase it at a fixed price at some future date: essentially, a form of secured borrowing.

Special Drawing Rights (SDRs) – an international reserve asset created by the IMF in 1969 as a supplement to the then existing reserve assets. It is currently valued in terms of a weighted basket of four currencies (US dollar, sterling, yen and euro).

Spot transaction is an agreement to pay the prevailing market price for a currency or financial instrument for delivery usually in two days time.

Supranational refers to an international government or quasi-government organisation.

Swap is a financial transaction in which two counterparties agree to exchange streams of payments occurring over time according to predetermined rules. Swaps can be used to change the currency or interest rate exposure associated with investments or liabilities.

Unhedged reserves refer to the part of the reserves where the currency and interest rate exposure is not hedged.

Value at Risk (VaR) measures the aggregate market risk on a portfolio. VaR is an estimate of the maximum potential loss in the value of a portfolio. For example, "99% of the time losses will not exceed $10 million over a two week period".

Yield curve plots the relationship between bonds' maturity and their yield.

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